

Global Governance Program Update & Financial Markets Overview

September 15, 2014

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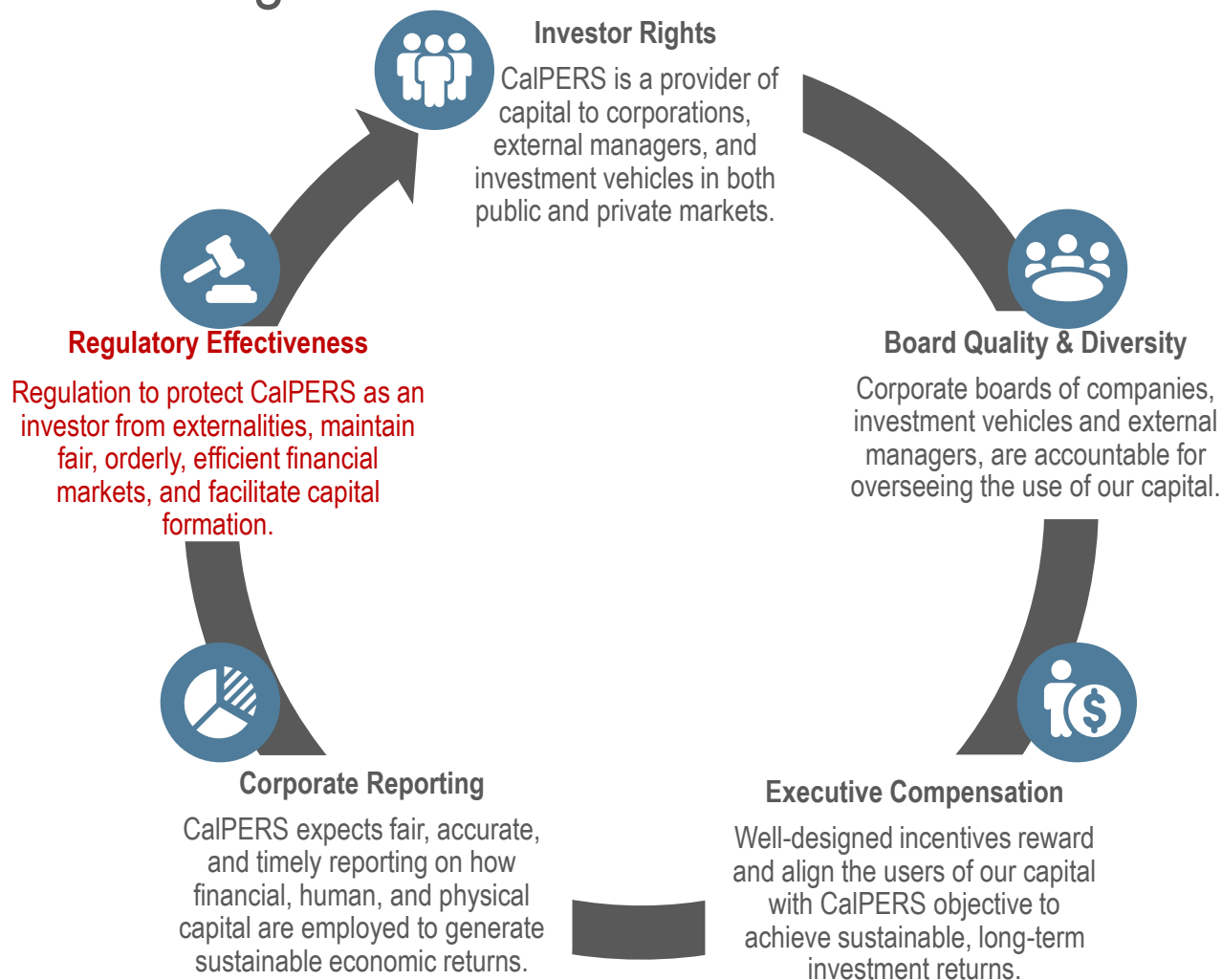
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Program Overview

Overview – Global Governance

- **We Aim to be a Principled and Effective Investor:** To deliver sustainable, risk-adjusted returns guided by CalPERS Investment Beliefs.
- **Grounded in Economics:** Long-term value creation requires effective management of three forms of capital - financial capital, physical capital, and human capital.
- **Core Issue Driven:** Investor rights, board quality and diversity, corporate reporting, executive compensation, regulatory effectiveness.
- **Work Streams:** Principles and Proxy Voting, Corporate Engagement, Financial Markets, ESG Integration, Institutional Relations and Knowledge Management.
- **Thought Leadership and Coalition Building:** Investor network leadership and the CalPERS Global Governance website.

Governance Program: Core Issues



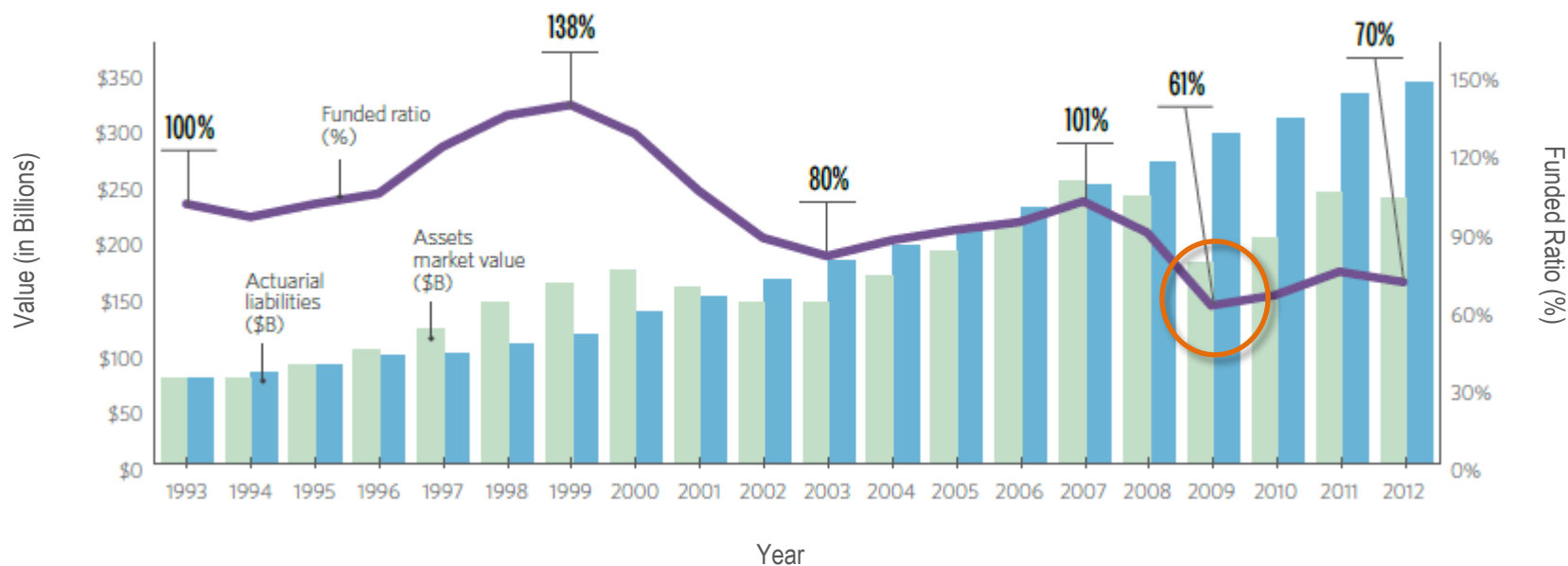
Financial Markets Overview

Financial Markets

Investment Belief 2	A long time investment horizon is a responsibility and an advantage	“A long time horizon requires that CalPERS advocate for public policies that promote fair, orderly and effectively regulated capital markets.”
2014-16 Business Plan Initiative Goal C	Financial Market Reform Principles	Develop financial market reform principles to influence global legislative and regulatory engagement and policy development.
INVO Roadmap 2013-15	ESG Investment Strategy – Strategic Objective	Ensure CalPERS acts as a principled and effective investor by advocating corporate governance and financial market reform , overseeing the effective management of the three forms of capital: financial, physical and human; and effectively engaging with portfolio companies and policymakers.

Why do financial markets matter to CalPERS?

CalPERS Assets, Liabilities and Funded Ratio (1993 – 2012)



Source: CalPERS Asset Liability Management Workshop

Causes of the Financial Crisis

Commissioned by the U.S. Congress to examine the causes of the financial crisis, the Financial Crisis Inquiry Commission's major conclusions included:

- This financial crisis was avoidable.
- Widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets.
- Dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis.
- A combination of excessive borrowing, risky investments, and lack of transparency put the financial system on a collision course with crisis.
- The government was ill prepared for the crisis, and its inconsistent response added to the uncertainty and panic in the financial markets.
- There was a systemic breakdown in accountability and ethics.

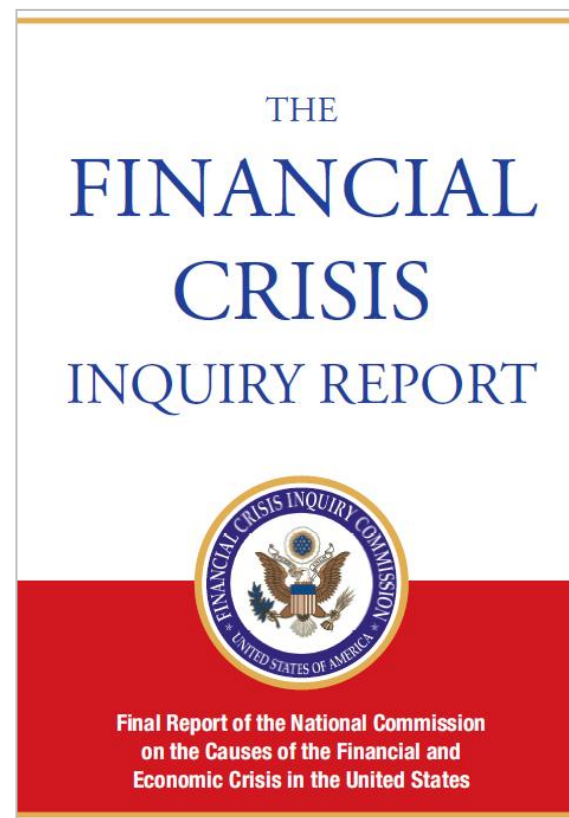
Causes of the Financial Crisis

“The financial crisis was avoidable...Financial executives and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks within a system so essential to the well-being of the American public.”

Phil Angelides

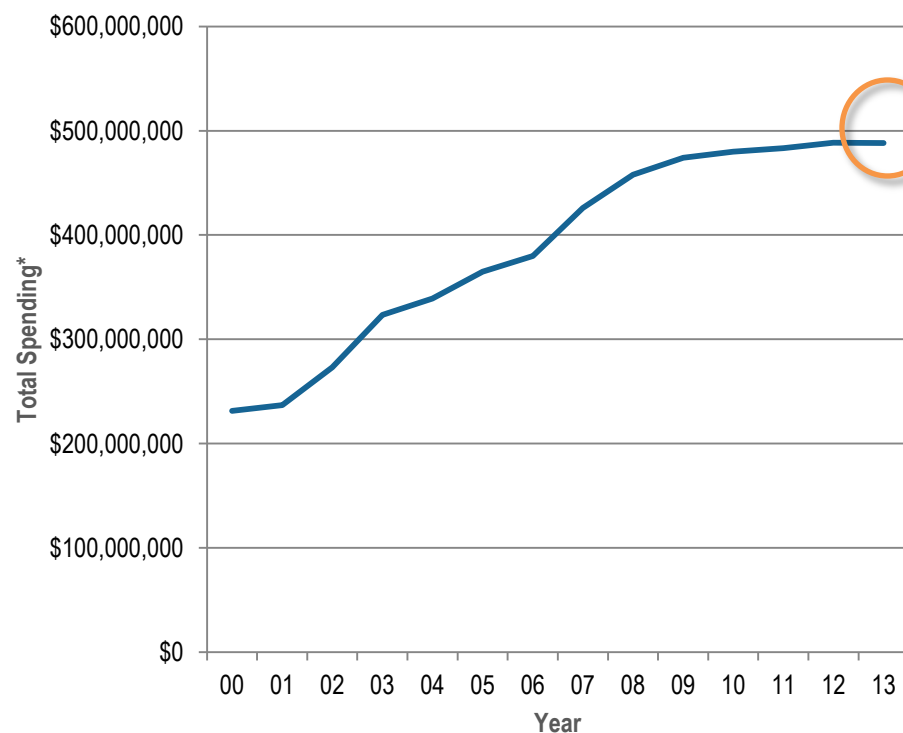
Chairman

U.S. Financial Crisis Inquiry Commission

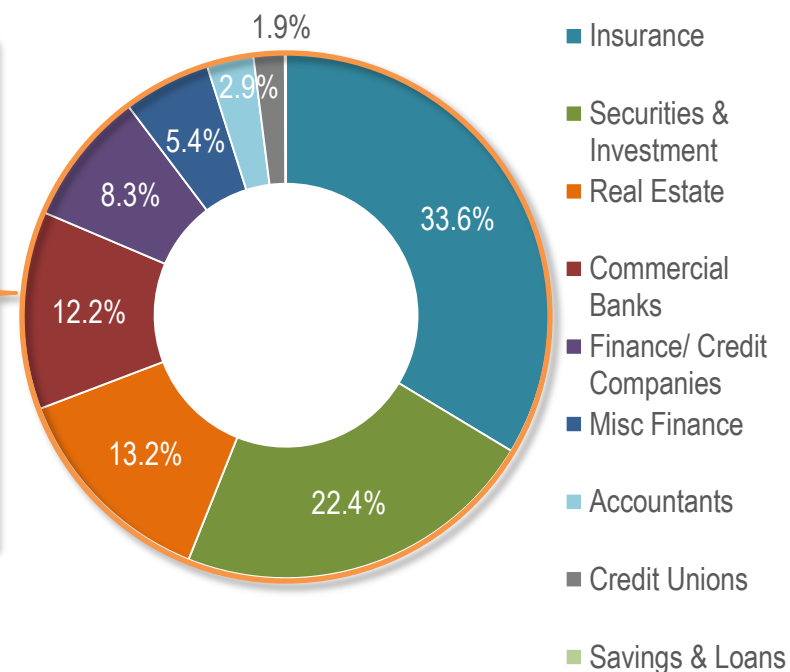


Finance Industry Lobbying

Total spending on lobbying by the finance industry heightened dramatically prior to the financial crisis and has remained steady since.



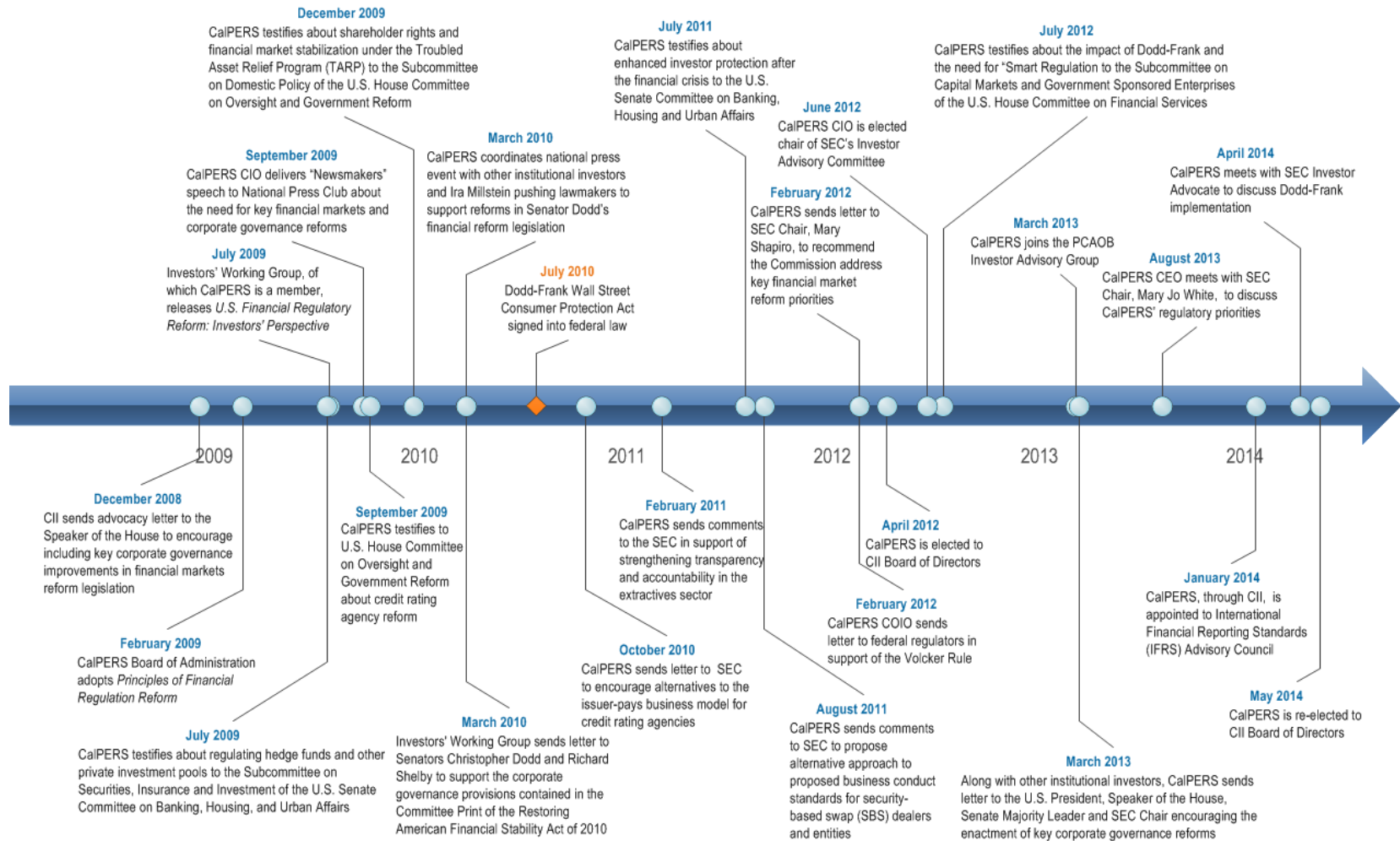
Snapshot: Lobbying Spending by Finance Industry Sector (2013)



Source: Center for Responsive Politics

*CalPERS spending included

Financial Markets Milestones



From-To Vision – Financial Markets Work Stream

Objective: Advance policies that protect CalPERS as a long-term investor from externalities, address systemic risk, and foster fair, orderly and efficient financial markets and facilitate capital formation.

From	To
Policy engagements driven by mitigating portfolio impacts due to global financial crisis	Strategic and focused domestic and international policy engagement based on portfolio risk
Periodic development and communication of investor perspectives to stakeholders and policymakers	Prioritized initiatives that strengthen CalPERS' profile as a thought leader in global financial markets policy
Varied approach to financial markets policy engagement	Regular assessment of and strong alignment with evidence-based best practices for policy engagement
Extensive collaboration with institutional partners on multiple financial markets policy issues	Focused collaboration with partners, industry groups and coalitions to improve impact

Principles of Financial Regulation Reform (2009)

In conjunction with leading public pension funds and plan sponsors in the United States, CalPERS developed financial regulation reform principles, aimed at restoring trust in financial markets. CalPERS' Board of Administration adopted the principles in February 2009. These principles included the following key elements:

- **Transparency:** Greater disclosure and transparency
- **Independence:** True regulatory independence
- **Corporate Governance:** An increased and effective shareowner voice in the capital markets
- **Investment Opportunities:** The preservation of institutional investors' freedom to invest in the full range of investment opportunities
- **Systemic Risk:** Earlier identification by regulators of issues that give rise to overall market risk that threaten global market stability

CalPERS Refreshed Financial Markets Principles

Building on the framework established in CalPERS' previously-adopted Principles of Financial Regulation Reform, Investment Office Senior Staff have refocused CalPERS' Financial Markets Principles to the following:

- **Transparency**

To promote full disclosure so that the market provides incentives that price risk and opportunity.

- **Governance**

To foster alignment of interest, protect investor rights and independence of regulators.

- **Systemic Risk**

For earlier identification by regulators of issues that give rise to overall market risk that threaten global markets and foster action that mitigates those risks.

Evaluation Criteria

Staff use the following criteria to prioritize engagement on policy issues:

CalPERS Principles	To what extent is the issue supported by CalPERS' Investment Beliefs, Financial Market Principles or other Statements of Investment Policy?
Materiality	<p>Does the issue have the potential for a meaningful impact on portfolio risk or return?</p> <ul style="list-style-type: none"> • Net Portfolio Performance: Relevant to improving portfolio returns or reducing risk. • Capital Exposure: Relevant to CalPERS' capital exposure in \$\$ terms. • Scale: Relevant to the number of companies in which CalPERS invests. • Evidence: Supported by empirical data, broad market consensus, or strong CalPERS' conviction that the issue will improve returns or reduce risk.
Capacity	Do we have the expertise and resources to influence a meaningful outcome? Do we have prior experience with engaging on the issue?
Timeliness	Is the issue time sensitive with a clearly defined deadline?
Likelihood of Success	Is there a likelihood of success that CalPERS action will influence an outcome which can be measured? Can we partner with others to achieve success? Can we add value to the debate?

2014-15 Policy Engagement Priorities – Derivatives

CalPERS Principles	<p>Transparency: Risks involved in derivatives are often hidden, especially with over-the-counter derivatives.</p> <p>Systemic Risk: Failed contracts or a failed major counterparty could wreak havoc in the system, as it did during the financial crisis. Critical issues not yet addressed.</p>
Materiality	\$700 Trillion Dollar Notional Value Market.. Played significant role in the 2008 financial crisis
Capacity	We have been engaged in derivatives related issues since the financial crisis. CalPERS has an active internal Derivatives Committee that reviews issues and provides expertise and guidance.
Timeliness	The issues are numerous and require constant tracking, monitoring and evaluation.
Likelihood of Success	Given the importance of particular issues, we must be successful in order to continue to participate in the market, but it is important to recognize this requires us to work with partners.

2014-15 Policy Engagement Priorities – Housing Finance Reform

CalPERS Principles	Systemic risk: As seen during the financial crisis, a failure in the housing finance market will have a significant impact on the financial system. It is important to have a fair and effective housing finance system.
Materiality	The US housing finance market is a \$10 trillion market in direct finance and provides the base for a derivatives market that is several multiples of the base market.
Capacity	CalPERS has internal expertise on housing finance reform which serves as a resource in evaluating issues and proposals.
Timeliness	Regulations have moved slowly in this area. Various plans are under consideration in Congress. We will be able to respond in a timely manner given our continued tracking. Additional expertise is available from contracted organizations.
Likelihood of Success	Success in this area would include convening partners to share views and develop consensus.

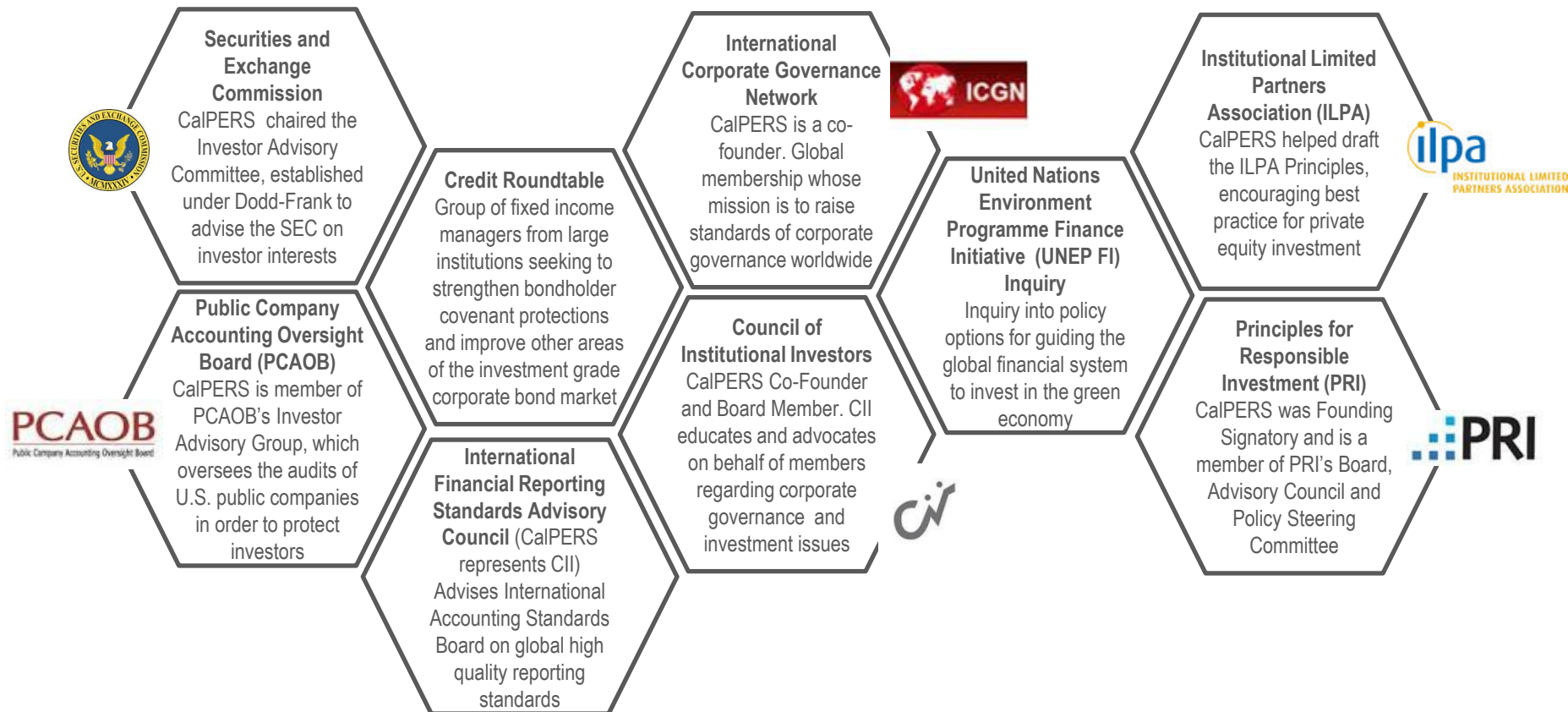
Policy Engagement Priorities – Credit Rating Agencies

CalPERS Principles	<p>Transparency: Credit Rating Agencies play an important role in providing information to the market which enhances transparency. They failed in this role prior to and immediately after the 2008 financial crisis.</p> <p>Systemic risk: Credit rating agencies had a significant role in the mortgage crisis which weakened the system.</p>
Materiality	<p>Certain markets cannot be created without Credit Rating Agencies. For example, the complex mortgage securities could not have been sold without the faulty ratings provided by the Credit Rating Agencies. We need to ensure that the agencies are regulated in a way that prevents a similar crisis.</p>
Capacity	<p>CalPERS has internal expertise on the importance of credit rating agencies to the system and expertise in evaluating the issues surrounding credit rating agencies.</p>
Timeliness	<p>Regulations have moved slowly in this area. We will be able to respond in a timely manner.</p>
Likelihood of Success	<p>Success in this area would include sharing CalPERS' views on credit rating agencies at the highest levels in the global discussion to promote coordinated global reforms.</p>

Continuing Work

	Priority	Description
Engagement & Thought Leadership	Policy Engagement	Advance public policies that align with CalPERS' Financial Markets Principles (through congressional testimony, public comment letters, special meetings)
	Perspective Development	Collaborate with partners to develop thought leader perspectives about financial markets public policies that promote long-term value creation (e.g, PRI Long-Term Mandates Paper, UNEP/PRI inquiry into sustainable financial markets).
Partnerships & Stakeholders	Boards/Committees/Groups	Participate on boards, committees and advisory groups who engage with policymakers and/or advance positions that align with CalPERS' Principles (e.g., PCAOB Investor Advisory Group, Council of Institutional Investors, IFRS)
	Partnership Enhancement	Focus on relationships with policymakers, institutions, and networks to increase the likelihood that CalPERS' engagements achieve their desired outcome.

Policy Engagement through Partnerships and Coalitions

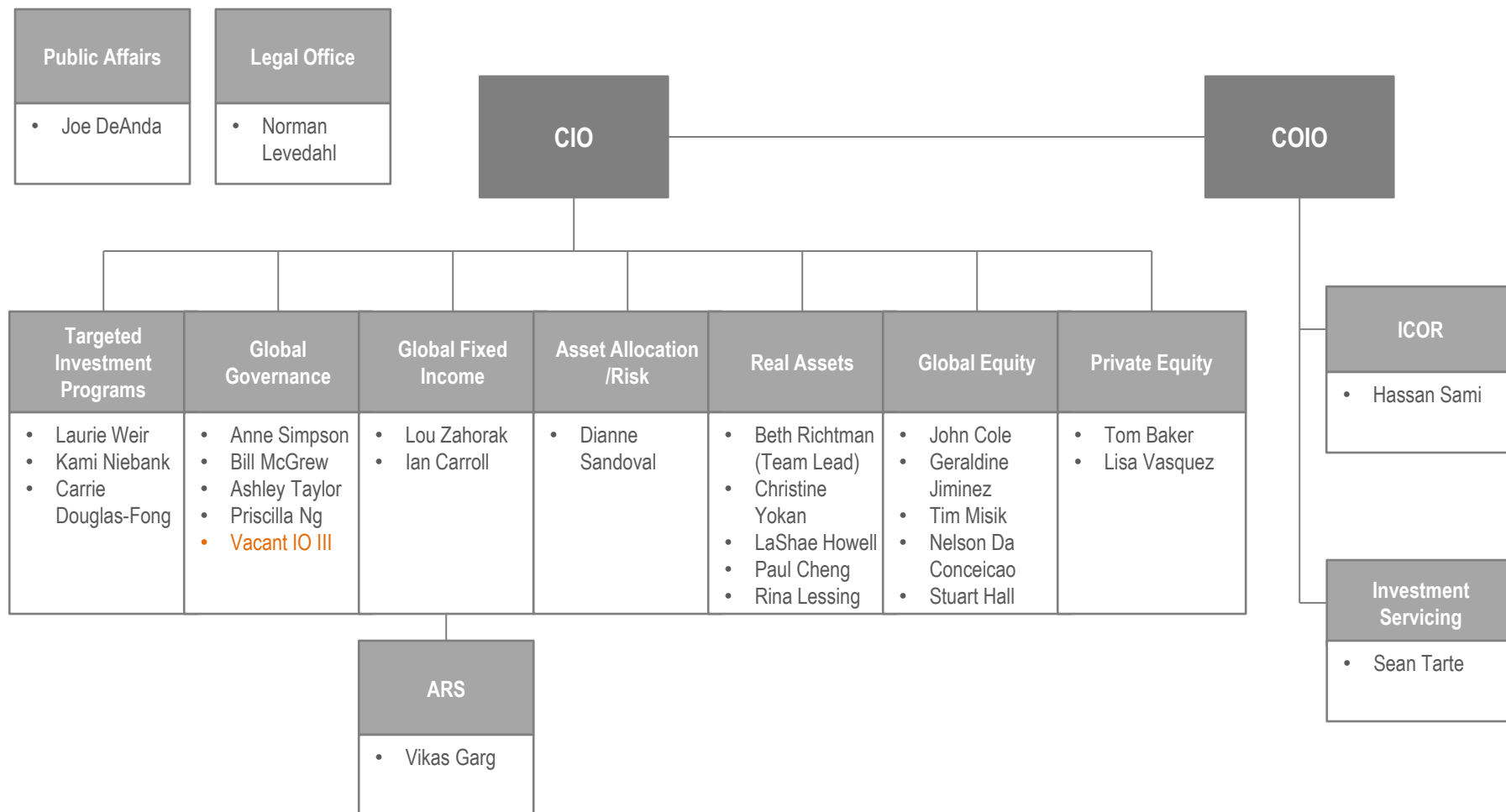


ESG Integration – Cross Asset Class Team Purpose

To work collaboratively to integrate relevant environmental, social and governance risk and opportunity considerations into investment processes and decision making across the Total Fund.

In line with the Investment Beliefs, our activities will help drive objectives outlined in Goal A of the Enterprise Strategic Plan to improve long-term pension and health benefit sustainability and support the 13/15 Roadmap Performance Objective of ESG Investment Strategy.

ESG Integration – Cross-Asset Class Team



Function	2014 Update	Lead
Dialogue	<ul style="list-style-type: none"> Monthly meetings featured extensive, robust and nuanced discussions Global Peer Exchange – quarterly calls and in person meetings 	Beth Richtman
Education	<ul style="list-style-type: none"> Two Tales of Trade Events Planned: Climate Risk & Integrated Reporting Seminars held with the Sustainability Accounting Standards Board (SASB) and Ceres - 3 more proposed Monthly News-Wrap up e-mail 	LaShae Howell, Paul Cheng
CalPERS Reporting	<ul style="list-style-type: none"> United Nations Principles for Responsible Investment reporting framework successfully completed across the total fund Toward Sustainable Investment & Operations Report Launched 	Ashley Taylor
Tools and Data	<ul style="list-style-type: none"> Working group on portfolio monitoring tool and data evaluation Building on Rapid Results Manager Expectations 	Sean Tarte, Nelson Da Conceicao

ESG Integration – Manager Expectations

FROM	TO
<ul style="list-style-type: none">• Varied understanding, interpretation and integration of sustainable investment considerations.• Lack of clarity given to internal staff or external managers on how sustainability considerations will or should be factored into manager selection, contracting or monitoring.	<ul style="list-style-type: none">• Asset classes have practices, within delegated authority and with the appropriate flexibility and recognition of differences amongst strategies and managers, for integrating sustainability considerations throughout the lifecycle of the relationship with internal and external managers.

ESG Integration – Manager Expectations

	FROM	TO	ACTIVITY
PHASE 1	Definitions <ul style="list-style-type: none"> Lack of consensus on definitions 	<ul style="list-style-type: none"> Clarity and consensus in the use of definitions 	<ul style="list-style-type: none"> Review & assess data sources internally and externally, vendor presentations (MSCI, GMI Rating's, Bloomberg, Sustainalytics), past consultant work done for CalPERS, Peer work Review SASB development of standards on materiality Review work of external managers
	Practice Inventory <ul style="list-style-type: none"> Internal: Lack of understanding of current inclusion of Sustainable Investment considerations in each asset class i.e. policies, principles, processes External: Lack of understanding of what others are doing in the market, what PRI, Ceres, ICGN have proposed 	<ul style="list-style-type: none"> Understanding of current inventory of CalPERS Sustainable Investment practices Understanding of external best practices 	<ul style="list-style-type: none"> Map out current inventory of internal current inclusion of ESG policies, principles, processes Map out inventory of external best practices Present to the Cross-Asset Class Team
PHASE 2	Establish Processes & Practices <ul style="list-style-type: none"> Lack of practices for staff and external managers 	<ul style="list-style-type: none"> Asset Class specific, and flexible, practices (within delegated authority) for integrating sustainability considerations throughout the lifecycle of the relationship with managers. 	<ul style="list-style-type: none"> Public & Private asset classes propose appropriate draft practices for their programs. Utilize common core considerations across fund Test and review results from pilot before wider roll out
PHASE 3	Evolve over time <ul style="list-style-type: none"> Lack of knowledge base and space to collaborate 	<ul style="list-style-type: none"> Sharing of best practices and lessons learned 	<ul style="list-style-type: none"> Present assessment of practices and results to discuss with SIOs and the INVO office. Work with program areas to help their practices improve for the benefit of the fund. Review practices & key lessons learned to ensure alignment with the Investment Beliefs

Principles and Proxy Voting – Voting Execution

- CalPERS Investment Policy for Global Proxy Voting states that proxy voting rights must be diligently exercised as part of our fiduciary duty. Staff reviews information provided by companies, market experts, investors, and proxy advisory firms to ensure votes are cast in line with CalPERS Global Principles of Accountable Corporate Governance (Principles).
- During the period April 1, 2014 to June 30, 2014 CalPERS voted in compliance with its Global Proxy Voting Principles at 7,344 company meetings – which included votes for 82,664 individual proposals, supporting 88% of management proposals and 67% of shareowner proposals.
- Share blocking is the “freezing” of shares for trading purposes at the custodian/ sub-custodian bank level in order to vote proxies. During the second quarter of 2014, staff did not vote at 4 company meetings due to share blocking – casting votes at these meetings would have prevented the rebalancing of portfolios. All other votes were successfully cast on behalf of CalPERS.

Principles and Proxy Voting – Shareowner Rights

- **Majority Vote Campaign** – Since 2010 CalPERS has engaged a wide range of domestic companies surrounding the adoption of majority vote for director elections. In 2013 staff began engagement efforts at another 50 companies with continued success – year to date we can confirm 43 of the 50 companies have committed to or adopted the CalPERS request. Staff will continue to engage the remaining seven companies and file shareowner resolutions where necessary.
- **Nabors Industries (NBR) Vote Calculation Shareowner Resolution** – CalPERS filed a shareowner resolution requesting NBR revise its vote counting methodology to a standard that counts uninstructed broker votes for quorum purposes only. Leading up to the June 3, 2014 AGM staff ran a full proxy solicitation and the CalPERS proposal would ultimately pass – receiving 62 percent shareowner support.

Principles and Proxy Voting – Shareowner Rights

- **Supporting Shareowner Rights** – CalPERS has been a longstanding proponent in the advancement of shareowner rights through proxy voting activity as highlighted by the number of shareowner rights resolutions CalPERS voted “FOR” through the first two quarters of 2014.

Shareowner Resolution	# of Proposals	Average Proxy Vote Support Level	Proposal Passed/ Implemented
Repeal Classified Board	15	84%	14 Companies w/ > 50%
End Supermajority Vote Requirement	12	67%	8
Majority Voting for Director Elections	28	58%	16
Appoint Independent Board Chairman	62	31%	4
Right to Call Special Meetings	13	42%	5
Allow for Written Consent	27	39%	0
Proxy Access	13	39%	5

Principles and Proxy Voting – Shareowner Rights

- **Vornado Realty Trust (VNO)** – After four consecutive years of failing to adopt a majority passed shareowner resolution to Declassify the Board of Directors – CalPERS withheld support from director nominees David Mandelbaum, Michael Lynne, and Daniel Tisch (the nominees received opposition levels of 75%, 61%, and 61% respectively).
- **Dominos Pizza (DPZ)** – Due to concerns the company had not adequately aligned a compensation program with shareowner interests CalPERS withheld support from Compensation Committee member Andrew Balson (received 31% opposition). CalPERS also voted “against” the company’s Advisory Vote on Executive Compensation (received 24% opposition) over these alignment concerns – specifically surrounding large discretionary payments made to company executives with limited disclosure.
- **Target Corporation (TGT)** – On December 19, 2013 Target confirmed the company was exposed to a massive data breach that included unauthorized access to credit card data of approximately 40 million customer accounts between Nov. 27 and Dec. 15, 2013. The Data Breach revealed that the company may not have been prepared for the significant risk in the area of cyber-security surrounding the company’s business in electronic commerce. Consistent with CalPERS Principles related to risk and cyber-security CalPERS withheld support from Audit Committee Chair Roxanne Austin (received 28% opposition) due to risk oversight failures leading up to the data breach.

Principles and Proxy Voting – Executive Compensation

- **2014 CalPERS Say-on-Pay Voting** – Staff continued to analyze and vote domestic say-on-pay resolutions – then proactively reach out to companies we voted “against” to communicate our rationale and seek appropriate resolution to CalPERS concerns. Year to date CalPERS had voted “against” 319 say-on-pay resolutions or 13% of the total proposals voted. Staff is in the process of completing delivery of letters to communicate company votes.
 - 2014 Say on Pay Trends:
 - Average shareowner “support” level for Say on Pay proposals was 91.6 percent.
 - Average shareowner “opposition” level for Say on Pay proposals was 8.4 percent.
 - 98 percent of the Say on Pay proposals in 2014 passed with a majority support.
 - 2 percent (48 companies) failed to receive a majority support
- **2014 Nabors Industries AGM** – Over continued executive compensation concerns CalPERS voted AGAINST the NBR say-on-pay proposal – which received a high level of opposition at 60 percent. Due to the ongoing pay issues at the company CalPERS withheld support from compensation committee chair John Lombardi who failed to receive majority shareowner support with 54 percent opposition. Staff will continue engaging the company these issues.
- **Say-on-Pay Director Withhold Votes** – Staff will monitor 49 companies that failed to receive greater than 50 percent shareowner support for their say-on-pay proposal in 2014. Prior to the 2015 AGM staff will recommend a withhold vote from Compensation Committee members at companies that have not adequately addressed shareowner concerns on executive compensation.

Global Governance website:
www.calpers-governance.org/

View and download Full Sustainable Investment Report at:
<http://goo.gl/J9BMHz> or scan the QR code

